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THE VANISHING FEDERAL BUDGET SURPLUS: WHAT HAPPENED?

by Gary S. Olson, Director

The fiscal year (FY) 1998 Federal budget marked a major turning point in the debate over the overall status of the budget. For the first time since FY 1969, the Federal budget closed the fiscal year with a surplus. Thirty years of discussion in the United States Congress as to how to eliminate a Federal budget deficit quickly turned into a discussion as to what to do with a Federal budget surplus. The change from a Federal budget deficit to a Federal budget surplus can be traced to a robust United States economy, modest Federal tax increases enacted in the 1990s, and restraint in Federal spending. However, as quickly as the Federal budget moved into a surplus beginning in FY 1998, a variety of conditions have moved the Federal budget back into deficit during FY 2002. This article provides a brief explanation as to how the Federal budget could move so rapidly from a surplus to a deficit situation.

As previously mentioned, the FY 1998 Federal budget marked the first year since FY 1969 that Federal revenues exceeded Federal outlays. At the close of FY 1998, Federal budget analysts were projecting growing Federal budget surpluses over the next decade. In fact, during January 2001, at the beginning of President George W. Bush's term in office, the nonpartisan Congressional Budget Office (CBO) stated that if current Federal tax and spending policies remained in play over the next 10 years the overall Federal budget surplus would total $5.6 trillion. This CBO report set off a series of actions by Congress that, when coupled with the national economic recession and the tragic events of September 11, 2001, moved the Federal budget quickly back into annual budget deficits.

Table 1 provides a recent history of Federal budget receipts, outlays, and projected year-end balances. The $69 billion Federal budget surplus recorded in FY 1998 marked the first Federal budget surplus since FY 1969 when a surplus of $3 billion was recorded. The Federal budget surplus continued to grow until FY 2000, when the surplus reached an all-time high of $236 billion. During FY 2001, the surplus declined to a level of $153 billion and President Bush's FY 2003 Budget Message released on February 4, 2002, projects a $106 billion budget deficit at the close of FY 2002. Based on the recommended policies and the economic forecasts contained in the President's budget request, the Federal budget will stay in a deficit situation until 2005, when a surplus of $61 billion is predicted.

Table 1
Federal Government Budget
Receipts, Outlays and Year-End Balance
(billions of dollars)

Fiscal Year	Receipts	Outlays	Surplus/ (Deficit)
1997	$1,579	$1,601	$(22)
1998	1,722	1,653	69
1999	1,828	1,703	125
2000	2,025	1,789	236
2001	2,011	1,858	153
2002	1,946	2,052	(106)
2003	2,048	2,128	(80)
2004	2,175	2,189	(14)
2005	2,338	2,277	61

Note: FY 1997 through FY 2001 represent actual figures. FY 2002 through FY 2005 are estimates contained in the President's FY 2003 budget.

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The turnaround in the condition of the Federal budget is even more notable when one realizes that when President Bush took office, his own Office of Management and Budget (OMB) was projecting a $282 billion budget surplus at the close of FY 2002. As a result of actions since early 2001, the OMB now is projecting a $106 billion budget deficit at the close of FY 2002. Table 2 provides a summary of how a projection of a $282 billion Federal budget surplus for FY 2002 can turn into a projected $106 billion budget deficit. Four major items have affected this $388 billion deterioration in the FY 2002 budget balance estimate. The first can be related to the impact on the budget of the 2001 Federal tax package which reduced the FY 2002 surplus estimate by $33 billion. The second change relates to the events of September 11, 2001, and the associated spending increases approved by Congress. These spending increases reduced the projected FY 2002 budget surplus by an additional $61 billion. The largest impact on the FY 2002 surplus is the $197 billion of negative adjustments attributable to the slowdown in the United States economy. This economic slowdown has resulted in major reductions in the estimates of Federal revenues and also has had an impact on Federal expenditures by increasing spending in human services programs and spending on Federal interest payments due to the projected declines in budget surpluses. The final item that has affected the FY 2002 budget projections is the $97 billion attributable to the President's proposed economic stimulus package, which has not yet been approved by Congress. The combination of these four items moves a projected FY 2002 budget surplus of $282 billion to a projected $106 billion deficit.

Table 2
The Vanishing FY 2002 Federal Budget Surplus
(billions of dollars)

FY 2002 Surplus Estimate Prior to Adjustments	$282
Changes to Surplus Estimate:	
Enacted Tax Changes	$(33)
Enacted Spending Increases	(61)
Impact of Revised Economic Forecasts	(197)
Proposed Economic Stimulus Package	(97)
Total Changes to Surplus Estimate	$(388)
Projected FY 2002 Year-End Balance	**$(106)**

Source: President's Fiscal Year 2003 Budget

In conclusion, the lesson to be learned from this rapid change in the status of the Federal budget is clear: It is very risky to base long-term budget decisions on 10-year Federal budget forecasts that can prove to be very unreliable as economic conditions change or national tragedies develop. This may lend some support to the practice in the State of Michigan and all other states of basing state budget policy on short-run forecasts which have a much better chance of being accurate as opposed to a long-term forecast.

"EDUCATION YES!": AN OVERVIEW OF THE PROPOSED SCHOOL ACCREDITATION PLAN
by Claire Layman, Legislative Analyst

Grading students on their academic performance can stimulate achievement, allow teachers to track student progress, and indicate to parents, businesses, and universities a child's academic ranking in comparison to other students. Grading public schools, some argue, could serve the same purposes: It could motivate schools to improve, allow the Michigan Department of Education (MDE) to track a school's progress, and give parents, businesses, and universities an indication of what to expect from that school's graduates.

State Superintendent of Public Instruction Tom Watkins and the MDE have proposed a school accreditation system, called *Education Yes!*, that would assign a grade to a school based on multiple indicators. The proposal sets three standards for student achievement, outlines a method for reporting a school's accreditation status to the public and to the schools, and aims to enlist the help of businesses, colleges and universities, and other community agents to help low-performing schools improve. Under *Education Yes!*, schools that did not meet minimum standards by 2005 would face sanctions under the Revised School Code.

According to the Department, the purposes of the new system are to focus on high standards, use multiple measures to evaluate school performance fairly, and lead the nation in school accreditation programs. Currently, approximately 30 states have an accreditation program in place; however, none of these states currently assesses the elementary, middle, and high schools differently, as this plan calls for. Further, the plan proposes that all schools, including specialized and alternative schools, career centers, special education schools, and early childhood schools be part of the accreditation plan.

Grades

Under the proposal, 75% of a school's grade would be based on the school's test data. While an elementary or middle school could use a locally-developed test that met certain requirements as its source of data, the Department anticipates that most districts would use the Michigan Educational Assessment Program (MEAP) test. The scores would be measured using three criteria: the status of the school's most recent scores, or, in the case of high schools, the percentage of students earning a Michigan Merit Award; the improvement or regression of scores or awards over three years; and the growth in individual pupil achievement across the district from the fourth to the seventh grade and from the seventh grade to high school.

(The Michigan Merit Award is a $2,500 scholarship given to high school students who take the math, science, reading, and writing MEAP tests, and who receive a 1 [Exceeded Standards] or 2 [Met Standards] on all four tests. Alternatively, students can earn a Merit award if they take all four tests, pass two of them, and receive a score in the 75th percentile or above on the ACT or SAT test, or achieve qualifying scores on the ACT WorkKeys job skills assessment test. Students must use the scholarship at a State university or college for eligible costs of their education. Recipients who attend an out-of-State institution receive a $1,000 scholarship.)

The remaining quarter of a school's grade would be a composite of several "performance indicators": family involvement; attendance rates; continuous improvement (in part, a school's progress on its unique school improvement plan); professional development for teachers that is targeted at improving student performance; extended learning opportunities, such as the availability of early childhood programs and before- and after-school programs; performance management systems, which are integrated assessment tools such as portfolios and profiles; and curriculum alignment, which refers to the match between instructional activities, State standards and benchmarks, and the local curriculum. In addition, high schools would be measured on their adoption of a four-year education and employment plan for each student, their drop-out rate, and the percentage of students enrolled in Advanced Placement classes and Dual Enrollment college classes, including vocational and technical college courses and work that leads to a State-recognized license.

Standards

Education YES! proposes that public schools commit to three standards: All Michigan elementary and middle school children will read independently and use math to solve problems at grade level; all Michigan students will experience a year of growth for a year of instruction; and all Michigan high school students, in addition to demonstrating high academic achievement, will have an educational plan preparing them for success.

Past accreditation programs, such as the North Central Accreditation system, required schools to meet over 240 standards, and typically set a threshold, such as the number of books in the library or the percentage of students who passed a test. In 1997, the State Board of Education established 10 standards for Michigan students; the current proposal does not address these standards.

Recording and Reporting School Data

Education Yes! would require a vast amount of data collection and analysis. Certain State systems already gather and break down school and student data; these include the Center for Educational Performance and Information (CEPI), a State agency that collects, analyzes, and reports data on the performance of schools and students. Under the plan, the Department would use and adapt information provided by Standard and Poor, a service currently contracted by the State to provide rating information on public schools.

The proposal calls for using a web-based, paperless format that would allow schools to enter data necessary for accreditation. Schools and districts would have the opportunity to verify every piece of data used in the system, and to appeal a rating using any additional data the school had. After a school received a rating, it would receive a customized report describing how to attain a higher grade.

The public would be informed of a school's rating, after the school had a chance to review its score, via the State's website, www.michigan.gov. In addition to the school's grade, a report would be available on each school's specific areas of evaluation, including all of the performance indicators and three points of testing evaluation--status, change, and growth.

Providing Support

If data indicated that a school was failing to achieve the standards set under *Education YES!*, the Department of Education would have to work with CEPI, the Department of Career Development, and the Department of Treasury to develop specific training in areas the data indicated were weak. For example, low reading scores could trigger teacher training in literacy. The information collected under the plan would be used to study the practices of high-performing schools so that other schools could adopt their methods and techniques.

Further, as *Education YES!* identified low-performing schools, the MDE would partner with businesses, colleges and universities, community agencies, existing accreditation groups, intermediate school districts, and statewide education organizations to help underperforming schools improve. At the same time, the Department would conduct a review of State and Federal programs focused on underperforming schools.

The No Child Left Behind Act: A Comparison

The new accreditation plan coincides with recent Federal legislation that mandates additional testing, attempts to hold schools accountable for their performance, provides low-performing schools with resources for improvement, and delivers more flexibility for schools receiving Federal funds.

Under the No Child Left Behind Act, signed into law in December 2001, all states must test students in grades three through eight every year in reading and math; in 2005, science tests also will be required. The states may develop their own tests, but a representative sample of students in each state must take the National Assessment of Educational Progress to set a benchmark for the state exams. According to the *Lansing State Journal* (February 2, 2002), Michigan will receive about $10.7 million from the Federal government to develop the new tests. The Act also provides substantial money to target teacher quality, and allows local districts to use more Federal money to hire new teachers, increase teacher pay, and improve teacher training and development.

Under *Education YES!,* elementary school students, beginning in fourth grade, not third, as the Act requires, also would be tested in reading and math; middle school students, grades six through eight, would be evaluated on math, reading, science, and social studies. The Act does not mandate testing in social studies skills. Like the State plan, the Act requires a report card to be issued annually, grading the school as a whole, with data disaggregated by race, disability, poverty, and ethnicity.

Under the Act, Federal aid will be available to schools that do not improve two years in a row, but schools that failed to improve six years in a row may be restaffed, restructured under a state takeover, or placed under the supervision of a private company. If a school district has been deemed as failing for two consecutive years, the district must provide transportation for a child to a new school. Further, beginning in the 2002-2003 school year, parents may transfer their children to a better performing public or charter school once a child's present school is identified as failing. Under *Education Yes!*, and under current State law, schools are subject to one or more sanctions if they are unaccredited for three consecutive years. One sanction permits the Superintendent of Public Instruction to appoint an administrator of the school until it becomes accredited. Another, like the Act, allows a parent or legal guardian to send his or her child to any accredited public school within the school district, and a third requires the school to align itself with an existing research-based school improvement model or affiliate itself with a college or university. Under the final sanction, a school may be closed.

According to the MDE, it intends to align *Education YES!* with the Federal Act.

History

The State has been attempting to use accreditation status to hold public schools accountable for their performance since 1990, when the Legislature passed Public Act 25. That Act required schools to be accredited by the State if they did not want to forfeit State school aid or additional school funding. Under Section 1280 of the Revised School Code, "accredited" is defined as certified by the State Board of Education as having met or exceeded State board-approved standards established for six areas of school operation: administration and school organization, curricula, staff, school plant and facilities, school and community relations, and school improvement plans and student outcomes.

The requirements needed to earn accreditation status have grown more rigorous since 1990. The most recent predecessor to *Education YES!* was a performance-based accreditation plan approved by the State Board of Education in May 1999. This plan was based on high achievement on the MEAP test, evidence that the school was committed to all students (i.e., there could be no disparity between race or class when test results were disaggregated), and a record of yearly improvement in MEAP scores. Critics of the 1999 plan contended that it was based entirely on MEAP scores, which could be problematic for a number of reasons. When the press predicted that as many as 1,000 schools would lose accreditation under this system, the performance-based plan grew more controversial.

In March 2001, the current State Superintendent of Public Instruction, Tom Watkins, was chosen by the State Board of Education to replace retired Superintendent Arthur Ellis. Superintendent Watkins halted the implementation of the performance-based system and ordered a new system that used multiple measures to accredit a school.

Reaction to *Education Yes!*

In order to garner public input, the MDE published the *Education YES!* proposal on its website, and invited people to respond via e-mail to the plan. According to the Department, 900 people responded to a questionnaire on the site. In addition, from December 2001 through January 2002, the MDE held six public hearings across the State, where the proposal was presented and the public could comment. At the February 14th State Board of Education meeting, Chief Academic Officer (CAO) William Burshaw presented the general findings from the survey and the hearings.

According to Mr. Burshaw, almost all respondents expressed support for the three guiding standards, and appreciated that they were clear but rigorous. The use of the performance indicators, or the non-MEAP measures, also was widely hailed. Many people expressed a desire for the performance indicators to count for more than 25% of a school's grade, and vigorously advocated for including the arts as a performance indicator.

Respondents were less enthusiastic about assigning a single grade to a school, asserting that one grade does not reveal enough about a school's specific strengths and weaknesses. Many suggested assigning multiple grades that reflect all of the standards, so the grade will be more diagnostic than punitive.

Critics of the plan contended that the proposal does not establish an accountability system in which the responsibility of individuals is clearly defined. Despite occasional references to the plan as an "accountability plan" by the Department and the press, it would not hold any particular school personnel responsible for the performance of a school. In addition, the plan does not include monetary resources to help low-performing schools (unlike the No Child Left Behind Act).

In response to the input the Department received, CAO Burshaw presented the Board with a series of recommendations:

- The arts, or possibly the humanities, should be included as a performance indicator.
- Schools should receive separate grades for each indicator and then a final, composite grade.
- The weighting of the final grade should be revised, so that one-third rather than one-fourth of the grade is an average of the performance indicators, and the remaining two-thirds of the grade, rather than three-fourths, consists of the test score results.
- An accreditation commission or committee should be established to determine a baseline standard for the grades. Past recommendations had included using an average, or bell curve, to set the grading criteria. Under this recommendation, the Commission would analyze school data first, establish the criteria for an A, B, C, etc., and then grade the schools using a rubric.
- Only schools that showed no improvement over three years, despite the best efforts of the Department, should receive an F, and therefore become unaccredited.
- Section 1280 of the Revised School Code should be repealed, as the six criteria for accredited schools do not match this proposal or the one before it.
- The 10 standards established by the Board in 1997 should be replaced with the three global standards set forth under *Education YES!*

Future Action

The State Board of Education passed the "framework" of *Education YES!* at its February 14th Board meeting, and met as a Committee of the Whole on March 4 to discuss the above proposals. The Board will take a final vote on the plan, including the new recommendations, on March 14. If the Board approves the proposal, *Education YES!* will be drafted as proposed legislation. Any changes in statute, such as the repeal of Section 1280, will require the involvement of the full Legislature.

SUMMARY OF THE EARLY-OUT RETIREMENT PROPOSAL FOR STATE EMPLOYEES

by Joe Carrasco, Fiscal Analyst

On February 7, 2002, in the release of the fiscal year (FY) 2002-03 Executive Budget Recommendation, Governor Engler proposed an early-out retirement plan for State employees. That proposal is now contained in House Bill (HB) 5732, which the Michigan House of Representatives passed on February 28, 2002. The bill containing the Governor's proposal for an early-out retirement plan also includes several changes aside from the early-out provisions. Following is a summary of the highlights of House-passed HB 5732.

Current Law Provisions

Members of the State Employees Retirement System's (SERS's) defined benefit plan are entitled to retire with full retirement benefits upon meeting the age and service requirements. Currently, those requirement are:

- Age 60 with 10 or more years of credited service (or five years in certain circumstances); or,
- Age 55 with at least 30 years of credited service; or

- Age 55 with at least 15 but less than 30 years of credited service; however, the pensions for these early retirees is permanently reduced by 0.5% for each month a member is less than age 60.

A pension under current law is calculated by multiplying 1.5% by the final average compensation (FAC), times the years of credited service. The FAC is determined by using the three consecutive years of service that return the highest average.

Proposed Early-Out Provisions

House Bill 5732 proposes an early out provision for most members of SERS. To be eligible, a member would have to have been employed by the State (or be on layoff status) for the preceding six-month period ending on the effective date of his or her retirement. Members who would be eligible for this early-out retirement plan are classified Civil Service employees, unclassified Civil Service employees, employees of the judicial and legislative branches who are not judges or legislators, employees of the Governor's office, and employees working in covered positions who are otherwise not eligible for a supplemental early retirement for covered employees under current law. Members who would be exempt from taking an early-out retirement under this proposal are those working as conservation officers and those working in covered positions who do qualify for a supplemental early retirement for covered employees as specified. (Covered employees are generally those working within the confines of a secure correctional facility.)

To qualify for an early-out retirement under HB 5732, a member would have to have a combined age and length of credited service that equaled at least 80 ("80 and out") as of November 1, 2002, or on the effective date of retirement, whichever would be earlier. There would be no minimum age requirement so long as the member met the 80 points. Members meeting these requirements would receive full retirement benefits the same as traditional retirees under current law, with one exception.

Members choosing to retire early under this proposal would receive an enhanced multiplier of 1.75%, rather than the 1.5% under current law as mentioned above. Thus, the retirement calculation for an employee taking an early retirement under this proposal would be:

1.75% times FAC times years of credited service

The window period for members to file for an early-out retirement would be relatively short. Members would have to file an application for retirement with the Office of Retirement Services between April 1 and April 30, 2002, and state a retirement date between July 1, 2002, and November 1, 2002. Members filing an application also would be able to withdraw that application for any reason until May 15, 2002; after that date, the application would be irrevocable.

Finally, members of SERS who transferred from the defined benefit plan to the defined contribution plan and met the "80 and out" requirements also would be eligible for this early-out retirement plan. However, these members would receive a benefit based only on 0.25% of FAC times years of credited service.

Extension of Retirement Date and Lump Sum Payments

Individuals eligible for the early-out retirement plan would be able to extend their retirement date up to 15 months (no later than February 1, 2004) from the original dates set forth in the proposed legislation. Members could extend their retirement dates provided that an extension was requested by their department director or designated by the Legislature or the judiciary. Requests for extensions for executive branch employees would have to be submitted to, and approved by, the Office of the State Employer and the State Budget Office by May 31, 2002. Legislative and judicial employees would have to submit their requests to the Office of Retirement Services by May 1, 2002; however; approval would be granted by legislative leaders or the chief justice, as applicable.

House Bill 5732 also would provide for the payment of both accrued sick leave and accrued annual leave. Accumulated sick leave would be paid in monthly installments over a period of five years, while accrued annual leave would be paid in a lump sum on or after October 1, 2002. The bill specifies that payments received under this provision could not be used for the purchase of service credit.

In addition to the early-out retirement plan provisions, HB 5732 contains provisions not related to the early-out retirement plan. These changes are as follows:

- **Health Advance Funding Subaccount** - The bill would create the Health Advance Funding Subaccount for the purpose of receiving deposits in years when the assets for normal retirement benefits are funded at 100% or more. In years when normal costs are fully funded, employer contributions could be deposited into the new subaccount. Funds from the subaccount could not be spent until the actuarial liability for health benefits was fully funded. Also, the Department of Management and Budget would be permitted to transfer amounts from the Health Advance Funding Subaccount to the employer's accumulation fund (the fund set aside for the pensions of future retirees) to cover any underfunding that might arise for normal retirement costs.

- **Duty and Non-Duty Disability Pensions** - The bill would establish a deadline for application for disability pensions of 12 months after the employee had separated from State service. A member could file an appeal to the retirement board to allow up to 24 months for application if "good cause" were determined. Current practice has been to allow up to 24 months from the date of separation from State service; however, there is no statutory provision for doing so.

- **Medical Examinations** - Currently, disability retirees under age 60 are required to undergo a medical examination to determine disability once per year for the first five years of retirement, and at least once every three years thereafter. House Bill 5732 would eliminate this requirement and specify instead that the retirement board could require a person to be examined at any time but not more than once per calendar year. Also, under current law, a disability retiree who is found to be physically able and capable of returning to work must be restored to State employment and the disability retirement allowance ended. This bill, instead simply would end disability retirement allowance benefits after six months of a finding that the retiree is physically capable of returning to work.

Fiscal Impact

Current Department of Management and Budget estimates indicate that approximately 8,800 State employees would be eligible to retire under this early-out plan, with an average annual salary of $68,600. Of those eligible, it is estimated that 5,300 would take advantage of this option and retire early. The Governor's plan calls for a replacement ratio of one to four, meaning that for every four employees who retired, only one eventually would be replaced, on average. Thus, all cost estimates take these factors into account.

Based on the salaries and the number of employees anticipated to retire early under this proposal, the State would realize an annual saving of $361 million. After the subtraction of all costs, such as health insurance, accumulated sick leave, and accumulated annual leave, the replacement of one in four employees, and the increase in pension liabilities for these new retirees, the State would realize a net GF/GP savings of $58 million annually.

As mentioned at the beginning of this article, HB 5732 has been passed by the Michigan House of Representatives. The next action will take place before the Senate Appropriations Committee. If approved by the Committee, the bill would move to the full Senate for passage. In order for the proposed window period for making an early retirement decision to begin, the bill would have to be signed into law by March 31, 2002.